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20 August 2008

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Dr John ~~Tamblyn~~
Chairman
Australian Energy Market Commission
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Dear Dr Tamblyn

Rule change proposal - Total factor productivity

The AER appreciates the opportunity to comment on the Victorian Minister for Energy and Resources (the Minister's) proposal to amend the National Electricity Rules (NER) to allow the use of the total factor productivity (TFP) methodology for the regulation of electricity distribution networks.

The AER supports the detailed consideration of a TFP-based price control as an alternative to the building blocks approach to price control. In particular, the AER supports a comprehensive review of the pros and cons of the use of the TFP methodology and for the range of models for its introduction to be properly and fully considered. More generally, the AER is mindful of the potential advantages of the use of more exogenous measures of costs to regulate network businesses, which may be less intrusive than the building blocks approach, rely less on detailed, firm-specific cost forecasts and possibly provide greater efficiency incentives. The TFP methodology is one such approach and its claimed advantages over other approaches in this regard need to be fully considered.

However, the AER has a number of concerns about the Minister's proposed rule change as the means of introducing TFP, specifically with respect to timing and the process of implementation. The AER notes that neither of these related matters were addressed in the Minister's submission.

In undertaking a review of TFP, and particularly in considering the timing for when any change in regulatory approach should take effect, the AEMC should have regard to the current transition towards a national framework for regulation of electricity distribution

networks. This is not only a significant reform program but it is still in its early stages. It is the AER's view that this transition should be given the opportunity to become better established before significant additional change to the underlying regulatory framework is introduced. In particular, one important pre-condition for the use of any TFP-based approach is the development of a full national cost data-base for DNSPs. Such a cost data-base is currently under development by the AER under the new NER provisions in Chapter 6, but this will take some time to be completed. The AER considers that the effective development and implementation of a TFP approach to network regulation is critically dependent on the collection of robust, consistent and reliable long term information about electricity distribution network costs and operational parameters, from a broad range of electricity DNSPs. As a practical matter, it would be most desirable for such a framework to be in place prior to the actual use of a TFP approach.

Similarly, the issue of whether the introduction of the TFP approach should be jurisdiction-specific, as is effectively being proposed by the Victorian Minister, needs to be considered against the background of the operation of a nationally consistent regulatory framework.

Further, it is generally preferable to apply TFP to firms in a relatively steady state environment (i.e. where the future profile of expenditure and demand is relatively smooth compared to historical levels). This is in stark contrast, however, to emerging trends in distribution network expenditure forecasts, particularly those emanating from NSW DNSPs in relation to their upcoming 2009-14 distribution regulatory periods. These indicate that expenditure over the 2009-14 period is forecast to be typically between 50-100 per cent higher than current periods. While it is unclear to the AER whether forecasts by DNSP's in other jurisdictions, such as Queensland, South Australia and Victoria, which are next due for price reviews, will show a similar step change in proposed expenditure, the potential impact of any such large shift in costs on the use of a TFP approach will need to be considered carefully.

I also want to note some specific timing implications for implementation of the Minister's proposal, were it to be adopted by the AEMC in its current form.

The AER is about to commence preparatory work in relation to the 2011-15 Victorian electricity distribution revenue reset. In January 2009 the AER will commence public consultation in accordance with the NER on the framework and approach (F&A) for this reset. The AER intends to release a position paper in relation to the F&A by the end of December 2008 and is required by the NER to publish its F&A by 31 May 2009.

Given the timing of the F&A process and the AER's related obligations under the NER, and considering the timing foreshadowed by the AEMC for its Draft Rule Determination (i.e. January 2009) and Final Rule Determination (i.e. April 2009) in relation to the Minister's proposal, the AER does not consider that it would be practical or prudent to introduce a TFP approach for the 2011-15 Victorian electricity distribution revenue reset. The reasons are outlined below.

The changes to the NER outlined in the Minister's proposal would require the AER to, among other things, publish detailed guidelines on the TFP methodology and its application following public consultation. The AER is mindful that it has been the approach in the NER that core regulatory guidelines for electricity distribution are developed and published prior to the commencement of an F&A process. This approach is in the interests of regulatory

transparency and certainty for affected parties, and enables the AER and affected parties to focus resources, and the limited time available for the F&A process, on the AER's regulatory approach for the upcoming reset, as opposed to consideration of broader issues that can and should be considered in the guidelines process. The AER considers that the development of national guidelines and supporting regulatory arrangements for the TFP methodology would be a significant undertaking, requiring resources and time consistent with the complexity of the issues at hand and the number of parties affected. Development of guidelines and other regulatory arrangements for TFP, prior to the commencement of the upcoming Victorian F&A consultation process, would require the development process for such guidelines to run in parallel with the AEMC's current review process for the Minister's proposal and in advance of the AEMC's Draft Rule Determination.

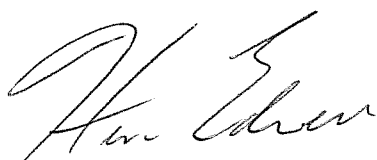
The AER does not consider that such a development process for TFP guidelines and supporting regulatory arrangements would be practical, in the interests of stakeholders or consistent with sound regulatory practice. At one level it would pre-empt the outcome of the Rule change process. Also, such a process could not take full account of any changes to the proposed model that may be adopted by the AEMC in response to the Minister's proposal.

Should the Minister's TFP proposal or any alternative be adopted by the AEMC, it is the AER's view that it should be given sufficient time following any amendment to the Rules to develop the supporting guidelines and other regulatory arrangements. This would require the Rules to set specific time-frames for this process. While this may mean it would be impractical to enable a TFP approach to be used for the next Victorian distribution price reviews due to start in 2009-10, the AER considers it important that the development and implementation of any TFP approach, whatever form it may ultimately take, is properly and fully considered.

The AER may provide a further submission in relation to the proposal after the release of the AEMC's Issues Paper in September 2008, where the above and other issues can be examined more fully.

Should you or your staff wish to discuss this submission, please contact Chris Pattas on (03) 9290 1470 or Darren Kearney on (03) 9290 1966.

Yours sincerely



Steve Edwell
Chairman
Australian Energy Regulator